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**TESTIMONY OF**  
**JULIE L. WILLIAMS**  
**ACTING COMPTROLLER OF THE CURRENCY**  
**Before the**  
**COMMITTEE ON BANKING AND FINANCIAL SERVICES**  
**of the**  
**U. S. HOUSE OF REPRESENTATIVES**  
**April 29, 1998**

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify on the recent proposed mergers of a number of large financial institutions. As you note in your letter of invitation, there have been many significant developments in the financial services industry in recent years, and these developments raise a number of important public policy issues. I commend the Committee for convening this hearing to focus attention on these matters.

Today, we are here to discuss two developments: mergers between large, superregional banks and thrifts, and a proposed combination between a banking company and a financial services firm designed to create a diversified financial conglomerate. The scale and scope of each of these mergers raises important questions about their impact on consumers and local communities; about their implications for domestic and international competition; and, about the preparedness of regulators to oversee the resulting organizations.

It is helpful when assessing the implications of these transactions to recognize that they are the product of long term changes in the financial services industry. The fact is that banking has been undergoing fundamental change for more than a generation now. Today's analysts speak in terms of the "evolution of the bank balance sheet," and evolution -- in the sense of long-term adaptive change -- is an apt way to consider these changes. Its manifestations are certainly familiar: the decline in core deposits and the proportionate increase in nondeposit liabilities; the migration of top-rated corporate borrowers from banks to the commercial paper market and the increased lending to smaller, potentially riskier firms and to consumers; technological developments that result in enhanced electronic product delivery; the rise in off-balance sheet activities; the search for fee-generating activities to expand and diversify income sources; the sustained efforts to reduce operating costs and compete more efficiently; and, increased intra-industry and nonbank competition in the U.S. credit markets that is now global.

In addition, legislative changes have removed most restrictions on the geographic scope of bank operations and reduced regulatory burdens that restricted more efficient bank operations. Banks, in response, have sought to adapt structurally, seeking out merger and acquisition partners to realign their franchises.<sup>1</sup> All of these and other market-driven developments are part of an evolutionary trend that dates back at least to the 1960s but that has gained noticeable momentum in recent years.

As the charterer, regulator, and supervisor of the national banking system, we at the Office of the Comptroller of the Currency (OCC) have been focussing on how such industry

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<sup>1</sup> These activities, combined with the failures of large numbers of banks and savings associations in the 1980s and early 1990s, have resulted in a significant consolidation of the banking system, one that has whittled the number of commercial banks from roughly 14,000 in 1980 to little more than 9,000 today.

restructuring will affect the safety and soundness of the National Banking System and the customers and communities served by national banks.

My testimony today, therefore, addresses the key issues you have raised from the perspective of a bank supervisor. I will first discuss the key safety and soundness issues we perceive and the steps the OCC has undertaken to address those issues. I will next discuss community, consumer, and competitiveness issues in relation to the recently announced merger activity. I will conclude by discussing the question you raised as to whether legislation is needed to provide smaller banks with the ability to compete on a level playing field with these emerging financial conglomerates. This last question, in fact, highlights an issue that has been of great concern to the OCC in connection with the current version of H.R. 10. To compete effectively in the financial services marketplace of the future, banks of all sizes need the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. Particularly when faced with the prospect of competing against giant financial conglomerates, banks -- of all sizes -- should not be subject to artificial constraints on their ability to compete. Moreover, banks must not be deprived of authorities that they have today under current law as they face the challenges of competition in the emerging financial services industry.

## **Supervisory Issues and OCC Plans**

### ***Overview***

Our supervisory approach to the transactions and organizations we are discussing today is based on our experience overseeing many large bank mergers in recent years, and our fundamental supervisory philosophy -- supervision by risk. Over the past five years, we have developed, tested, and refined this supervisory strategy, which we believe is uniquely suited to address the special challenges posed by bigger, more complex banks. Whereas our historical supervisory practices were essentially reactive, supervision by risk better enables us to anticipate and deal with bank problems before they become entrenched. These procedures require OCC examiners to assess a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas.<sup>2</sup>

The supervision by risk framework provides a consistent and common structure for risk assessment for national banking companies. Through this process, examiners are required to draw conclusions on the quantity of risk and quality of risk management in all nine risk categories for each of our banks. The framework established by supervision by risk also

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<sup>2</sup> The OCC has identified risk categories in the areas of credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation risks. Most bank activities contain one or more of these risks.

allows for greater comparability of examination findings between and among banks. Peer analysis is a regular aspect of the large bank supervisory process.

In addition, the OCC is completing a revision of its examination guidance for large banks, building on our existing supervision by risk framework. This revised guidance, the Large Bank Supervision Handbook, represents an enhancement to our evaluation of bank risk management processes, centered on the evaluation and management of existing and emergent areas of bank risk. The principal addition to the new Handbook is the specification of minimum conclusions that examiners of large banks must make during each 12-month supervisory cycle in assessing the nine categories of risk.

### ***Supervision Issues***

Applying the supervision by risk approach, OCC resident staff at each of the institutions involved in the recently proposed transactions have already begun to coordinate their supervisory strategies, identifying each organization's strengths and weaknesses. They will closely monitor their banks to ensure that appropriate risk management controls are maintained in the companies during the combination process and adequately implemented in the proposed combined companies. Examiners will assess and measure risks within each company and then integrate the risk profiles of the different entities and develop a combined risk assessment and supervisory strategy.

In addition to this work with respect to particular institutions, we plan to gather some of our examiners most experienced in large merger and combination transactions for a special meeting to review the issues they encountered in those transactions and identify "best practices" in how those issues were addressed by the institutions involved and by OCC supervisors.

We already know from experience, however, many of the near-term and long-term challenges banks involved in large mergers and combinations face. For example, beginning with the transition, management must establish clear business plans, lines of authority, and accountability within the new company. Anything short of a tightly controlled merger transition process can lead to significant disruptions of ongoing business. Execution is crucial. Other merger transition issues that management must address include the departure of key management and technical personnel at the time of the merger announcement or shortly thereafter, the challenge of combining operational and information systems without interfering with ongoing operations, and the retention and enforcement of necessary risk management controls and systems. Our experience also demonstrates that cost-cutting designed to achieve post-merger savings must not debilitate essential internal controls and audit functions.

We also know that different issues will emerge after the transition phase in connection with ongoing supervision of the combined entity. Some of these post-merger supervisory issues include ensuring that the combined entity can process and monitor larger volumes of transactions, verifying that risk management systems identify risks to the bank in the large, complex organization, and evaluating whether management information systems are adequate to support critical management decision-making in the new organization.

Let me now turn to a fuller discussion of these issues, and our supervisory approaches to them.

*Concentrations.* To invest large quantities of funds efficiently, larger entities generally tend to engage in transactions of larger size. Larger loan and product transactions will, by their nature, be more visible, particularly if there are problems, leading to potentially increased reputation risk.

To address these types of concerns, OCC examiners focus on areas of highest financial risk at the affected companies and ensure they have a clear understanding of how those risks will be addressed by bank management. As an example, examiners will closely supervise efforts by bank management to identify and control their loan and investment concentrations and ensure that reserves and capital levels are appropriate for retained risks. The OCC issued Loan Portfolio Management Guidance last month to promote more sophisticated loan portfolio management efforts by banks. Examiners will also evaluate how bank management controls firmwide liquidity and avoid reliance on a small number of funds providers or markets. They will also ensure that appropriate contingency plans are in place in the event large funds sources are unable to continue providing funds. As the merger transition occurs, examiners will monitor the merged entity's development of new or revised policies, operating processes, and controls governing financial risk. We also use Ph.D. economists from our Risk Analysis Division to evaluate more effectively bank efforts to identify, measure, monitor and control asset and liability concentrations.

*Talent Depth and Drain.* A significantly larger firm providing more services to more customers can stretch the capacity of managers at all levels. There will be an increased need to retain and recruit capable executives, line managers, risk management personnel, and back office staff to manage the larger and more diverse operations. During and after the merger process, however, key managers and executives in operations or business lines may depart, resulting in insufficient expertise to manage systems of merging companies or to ensure that appropriate levels of customer service are maintained at the new combined organization. Particularly when "golden parachutes" are widespread and generous, valuable senior managers may elect to leave. Management must address the retention and continuity of critical staffing in their merger plans.

OCC examiners monitor changes in bank personnel and review the actions of bank management to mitigate undesired attrition. When they identify personnel gaps that present supervisory concerns, the Examiners-in-Charge (EICs) bring these issues to the attention of executive bank management and require that appropriate actions be taken.

*Technology/Management Information Systems.* Merging management information systems and automated transaction systems to common platforms often presents considerable challenges in bank mergers. Bank management will need to ensure that core business activities remain viable throughout the transition and that integration processes are continually confirmed, verified, and audited. Computer systems will need to capture huge volumes of data and convert data into quality management information on a timely basis (including profitability analysis, stress testing for various economic and market scenarios, financial risk modeling, etc.). At the same time, the technology used must serve the needs of the bank and its customers, for example, providing for efficient cash management processes and accurate and timely account statements. The merging institutions must also inventory systems, identify vulnerabilities and develop plans to ensure Y2K compliance. Management must decide promptly which systems can be integrated now and which systems must run parallel, with an appropriate systems linkage to ensure that effective risk management mechanisms remain in place, and be integrated after the year 2000, to avoid disrupting Y2K remediation efforts.

OCC examiners evaluate and monitor the respective bank's merger-related project plans, including those related to operational systems, to ensure that the integration process can be implemented effectively by bank management. Examination staff will continue to evaluate and monitor the risk management processes of ongoing core businesses, including appropriate transaction testing, to ensure that key information systems enable quality oversight and control by bank management. Examiners evaluate how management has allocated personnel, technology, and capital. When assessing information technology and management, examiners must ensure that adequate management information systems support critical management decision-making. Critical information must be readily accessible, and examiners must verify the accuracy of new or renovated reports, risk measurement models, or analytical tools based on information obtained from the new organization. Examiners also will be particularly watchful that cost-cutting designed to achieve post-combination savings does not debilitate essential internal controls and audit functions.

In addition, the OCC is monitoring the Y2K readiness of the merging banks on an ongoing basis to evaluate whether they address all significant Y2K issues in advance of January 1, 2000. For mergers envisioning systems integration prior to completion of Y2K conversions, we will review the merger plan to make sure it addresses Y2K issues. If merger plans call for keeping mission-critical operations separate until after January 1, 2000, we will verify that the Y2K project plan of the merged entity is revised appropriately and sufficient resources are committed to get the job done efficiently and effectively.

*Scale of Risk Management.* Management of the merged financial institution will need a strong risk management function to measure, monitor and control risk across the large and complex organization. In particular, risk management systems must identify risks to the bank in the resulting business. They also must take into account how nonbank activities within a banking organization affect the bank.

The assessment of risk management is a fundamental tenet of the OCC's supervision by risk program. OCC examiners include specialists in the areas of credit, capital markets, compliance, asset management, and technology risks, positioning the OCC to identify and respond more quickly to evolving risks within the banks. As noted above, our examiners and specialists are already developing supervisory strategies and objectives in each of these areas for the merged entity. When assessing risk management systems, examiners consider the bank's policies, processes, personnel, and control systems. We are also using quantitative methods to better supervise the underlying portfolios of large companies. These techniques supplement an examiner's ability to review individual transactions, and permit a more systemic approach to risk identification and measurement.

*Transactional Volume.* In these large, financially complex companies, the volume of transactions required to be processed will be huge. The combined organization's systems must be able to capture, process and monitor millions of customers and their transactions daily.

Transaction risk transcends all bank divisions and products. Examiners review transaction risk in all of a bank's business lines and focus their review of transaction processing by determining the quality of internal controls, audit coverage, information systems and development, the complexity of products and services, and management operating processes. Examiners also ensure merger and operational integration planning has appropriately taken into consideration all of the necessary factors to address transactions risk and ensure that transaction processing is conducted without harm or disfavor to bank customers, causing related reputation risk to the institution.

### ***Supervision of Global Banks***

The latest wave of merger announcements, without question, takes our challenges to a new level. There is no individual risk, or difficulty, associated with these combinations that we have not encountered before. However, the size and scope of some of these mergers are unprecedented in the United States, and are creating a new tier of world-class banks. Indeed, this phenomenon is not limited to the United States. In the last two years, there have been announcements of bank combinations similar in size and scope to those occurring here in Japan, Switzerland, and France.

Given this worldwide trend, the international regulatory community has been working together for some time to ensure that adequate mechanisms are in place to supervise these global banks. The OCC has been participating in this through our work on the Basle Committee on Banking Supervision, which meets under the auspices of the Bank for International Settlements in Basle, Switzerland. The Basle Committee has established principles governing the supervision of internationally active banks headquartered in the G-10, with the focus on preventing banking companies from taking advantage of different legal and supervisory regimes in a way that impairs safety and soundness. The Basle Committee has undertaken agreements to: harmonize basic approaches to prudential requirements (capital being the most notable); ensure that all banking activities within a financial company are supervised on a consolidated basis, regardless of where those activities are conducted; and ensure that adequate, timely information exchange takes place between supervisors.

In 1996, the Basle Committee took note of the increasing trend toward the formation of cross-border financial conglomerates and formed the Joint Forum on Financial Conglomerates, of which the OCC is also a member. The Joint Forum is comprised of banking, securities, and insurance regulators from 13 countries, and is developing principles governing the supervision of global financial companies that operate in at least two of the three financial sectors. While the Joint Forum is not attempting to unify methods of regulating the different financial sectors, it, like the Basle Committee, is focussing on ensuring nothing slips through “supervisory cracks,” and on the critical issue of ensuring adequate information exchange between supervisors.

The OCC has actively contributed to, and learned from, these international groups and we will continue to do so. However, we have long had to deal with issues of supervising across borders, and have significant on-the-ground experience in doing so. Indeed, over 25 years ago the OCC established an office in London in order to supervise national banks’ European operations. So, while not looking at new issues, the OCC and our domestic and foreign counterparts are looking at these issues with renewed vigor to ensure that worldwide supervisory arrangements are adequate for the new and emerging global banks.

### ***Community, Consumer, and Competitiveness Issues***

As you noted in your letter of invitation, policy makers must also consider the impact of such mergers on communities and consumers. Several of the key issues we see in these areas are discussed below.

*Community Reinvestment Act (CRA) implementation and investment in community development.* The implementation of CRA becomes more logistically challenging for the bank and its regulators as a bank increases its size and branches across states. The goal of CRA is to ensure that banks help meet the financial needs of the communities in which they are chartered



to do business. But that achievement can be harder to evaluate when a bank's main office is located thousands of miles away in another state.

Congress anticipated this situation, however, in crafting interstate branching legislation, and bank regulators have revised their examinations and procedures accordingly. As a result of the Riegle-Neal legislation, banks operating in more than one state are rated not only for their performance overall, but also separately for performance in each state in which they are located, and each multi-state Metropolitan Statistical Area in which they operate. Accordingly, the OCC evaluates a bank's CRA performance in all of its relevant CRA geographies. CRA, however, does not now apply directly to a bank's non-bank affiliates, even if they sell products originated by the bank.

The OCC currently is working to make its CRA examination procedures more consistent throughout an entire institution and across the population of large banks. Specifically, with respect to the application of CRA to large banks, the OCC is using special teams comprising its most experienced CRA examiners to conduct CRA examinations in 1998 at large national banks with multistate operations. The results of these initiatives will help us improve consistency and efficiency in scoping CRA examinations, enhance consistency in the application of standards under the new CRA rule, and provide more meaningful and usable public evaluations of the CRA performance of large institutions.

Institutions planning to engage in a series of acquisitions have substantial incentives to have a strong CRA record. Large national banks and their community development partners are the primary investors in community development corporations, community development projects and other public welfare investments. The vast majority of CRA lending commitments in recent years have been made by large banks active in mergers and acquisitions. Many mergers, therefore, have resulted in an acquiring bank making additional CRA commitments. In fact, increased size may benefit community reinvestment and development activity, moreover, in that larger banks have enhanced capacity and improved technology to support their lending activities and to provide innovative products, investments, and services.

Furthermore, to preserve CRA advances as the industry consolidates, it is OCC policy to require the surviving bank in a merger to indicate in its application -- on the public record -- whether it will honor the commitments made by the target bank to community organizations (or similar entities) and if not, to explain the reasons and the impact on the affected communities. If an acquiror indicates it does not plan to honor the commitments made by the target bank, we will consider that to be a significant issue that will result in a removal of the application from our expedited review procedures, and we will investigate the situation as part of the application process. The OCC is the first federal bank regulator to have such a

requirement of bank merger applicants. Since we initiated this procedure, no acquiring bank has indicated that it would not honor CRA commitments previously made by a target bank.

*Cross-marketing products.* If cross-marketing of non-bank products is an important strategy of the combined enterprise, it is essential that firms provide customers adequate information regarding the nature of the products they offer -- most particularly when an uninsured product is offered to a bank customer. An efficient market depends on individuals making informed choices.

Bank supervisors have experience in this area. The OCC and the other banking agencies that are members of the Federal Financial Institution Examination Council (FFIEC) published interagency guidance on this issue in 1994, recognizing the growing importance of the sale of nondeposit products by banks. Earlier this year the FFIEC, which I now chair, began a project to explore whether a uniform interagency regulation should be adopted to update and formalize this earlier guidance addressing sales of securities and insurance products by banks and thrifts.

The ability of companies to cross-market products to customers of their affiliates is facilitated by the ability of these various institutions to share customer information within the corporate family. The amendments to the Fair Credit Reporting Act (FCRA) that Congress adopted in 1996 allow affiliated companies to share their customer information provided it has been disclosed to the consumer that this information may be shared, and the consumer is given the opportunity to direct that the information not be disclosed.

The reality of diversified financial institutions underscores the importance of responsible corporate information sharing practices. These companies may possess information bearing on crucial and very personal aspects of a consumer's life -- including medical, credit and investment information. Financial conglomerates that are sharing customer information pursuant to the provisions of the FCRA need to make sure that their customers have an informed and realistic opportunity to "opt out" of having their personal information shared among affiliates in the conglomerate. Failure to deal responsibly with this issue risks a customer backlash that could disable the company from utilizing one of its most precious resources: its customer information.

As banking organizations grow and diversify, this is an area where the OCC will be paying increased attention.

*Fees and costs for consumers.* Although economic literature is not definitive on the specific impact of large mergers on consumer account fees, Federal Reserve Board surveys have shown that fees for deposit account services are higher at multi-state banks than single-state banks,

and surveys by some public interest groups indicate that big banks charge higher fees than small banks for many products.<sup>3</sup>

The pricing of bank products and services is complex, and it is difficult to ascertain precise reasons for the differences in prices. This is an area where the OCC will remain vigilant, with a particular concern about access to credit and other financial services by low- and moderate-income individuals.

It is important, however, not to lose sight of the potential benefits of these mergers. For example, large banks may offer the convenience of a wider array of services, for which some consumers are willing to pay through a combination of higher fees and lower interest rates. Technological advances at large banks may also result in enhanced services and lower barriers to entry. Also, despite the reduction in the absolute number of banks, the number of banking offices has continued to increase over time, going from 58,100 in 1986 to more than 67,000 in 1997. Large banks tend to have more extensive ATM networks and are more experienced in offering in-home banking. The number of ATMs keeps expanding, growing significantly over this period from 64,000 to more than 165,000. The bottom line is that market for deposit accounts remains highly competitive, and there are choices available for consumers. For the foreseeable future, there should continue to be healthy competition in the market from community and mid-size banks, ensuring that consumers will have a wide variety of services to choose from.

*Credit availability.* Larger institutions are “commoditizing” more products and using decision technology, such as credit scoring systems, to make credit decisions. Although credit availability in general has increased as the banking industry has consolidated, the long-term effect of increased reliance on decision technology for credit availability is unclear. The OCC will continue to monitor this area aggressively to ensure fair access to credit.

Economic studies find conflicting results concerning the impact of mergers and bank size on small business lending.<sup>4</sup> Pre-merger business strategy is apparently an important

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<sup>3</sup> See Board of Governors of the Federal Reserve System, *Annual Report to the Congress on Retail Fees and Services of Depository Institutions*, June 1997. See Public Interest Research Groups (PIRG), “Big Banks, Bigger ATM Fees: A Third PIRG National Survey of ATM Surcharging Rates,” at <http://www.igc.org/pirg/consumer/banks/atm98/index.htm>. Also, see Steven A. Holmes, “Huge Bank Mergers Worry Consumer Groups,” *New York Times*, April 19, 1998, p. 19.

<sup>4</sup> See, for example, Whalen, G., “Out-of-State Holding Company Affiliation and Small Business Lending,” Economic and Policy Analysis Working Paper 95-4, Office of the Comptroller of the Currency (September 1995); Strahan, P.E. and J.P. Weston, “Small Business Lending and the Changing Structure of the Banking Industry,” *Journal of Banking and Finance* 22 (forthcoming); and Berger, A.N., A. Saunders, J.M. Scalise, and G.F. Udell, “The Effects of Bank Mergers and Acquisitions on Small Business Lending,” *Journal of Financial Economics*,

factor: mergers tend to increase lending to small business when the acquiring bank has a strong small business lending strategy.<sup>5</sup> This suggests that acquisitions made by large banks that use new credit scoring technologies to make small business loans could enhance credit to small businesses.

*International Competitiveness.* Assuming the challenges of managing and supervising these global banks can be met, which I believe they can, then there will be significant benefits to the United States economy from these mergers, due to the increased business opportunities for U.S. banks. Moreover, the banks themselves will have opportunities to reduce their risk through greater sources of diversification. Finally, consumers here and in other countries stand to benefit from the increased price and product competition that will result.

### **Ensuring the Competitiveness of Smaller Banks**

The third question raised in your letter of invitation was whether legislation is necessary to provide smaller banks and financial services firms with the ability to compete on a level playing field with these newly created entities. Your question, in fact, highlights an issue that has been of great concern to the OCC in connection with the current version of H.R. 10. In order to compete effectively in the financial services marketplace of the future, banks of all sizes need to have the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. Particularly when faced with the prospect of competing against conglomerate financial titans, banks -- of all sizes -- should not be subject to artificial constraints on their ability to compete.

Yet, H.R. 10 would unfairly tilt the playing field in favor of large financial conglomerates by denying potential competitors the ability to compete using the corporate organizational form that is most efficient for them. This is a concrete illustration of why it is crucial that financial modernization legislation allow new financial activities to be conducted in bank operating subsidiaries as well as bank holding company affiliates. Moreover, H.R. 10 would also deprive banks of authorities they have today that could help them remain competitive. These aspects of H.R. 10 need to be changed in order to enable banks of all sizes to compete effectively with the conglomerate financial firms that the legislation would authorize.

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forthcoming.

<sup>5</sup> Peek, J. and E.S. Rosengren, "Bank Consolidation and Small Business Lending: It's Not Just Bank Size That Matters," *Journal of Banking and Finance* 22 (forthcoming).

## **Conclusion**

The recently proposed mergers reflect continued evolution in the banking industry in response to legislative, regulatory, and competitive changes. These mergers raise a number of important issues, including issues related to the regulator's ability to supervise effectively financial conglomerates and larger banks. Although confident we can handle these challenges, we are not complacent. One of the compelling lessons of the past is that we must never relax our supervisory vigilance.

Thank you for the opportunity to present the OCC's views. I will be pleased to respond to any questions you may have.